# DOW THEORY LETTERS INC.

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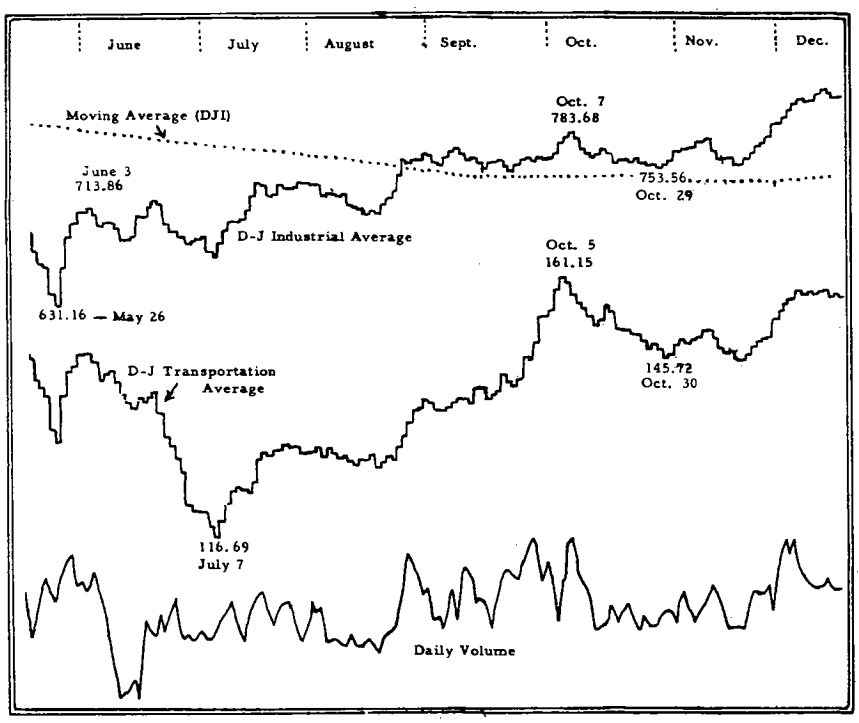
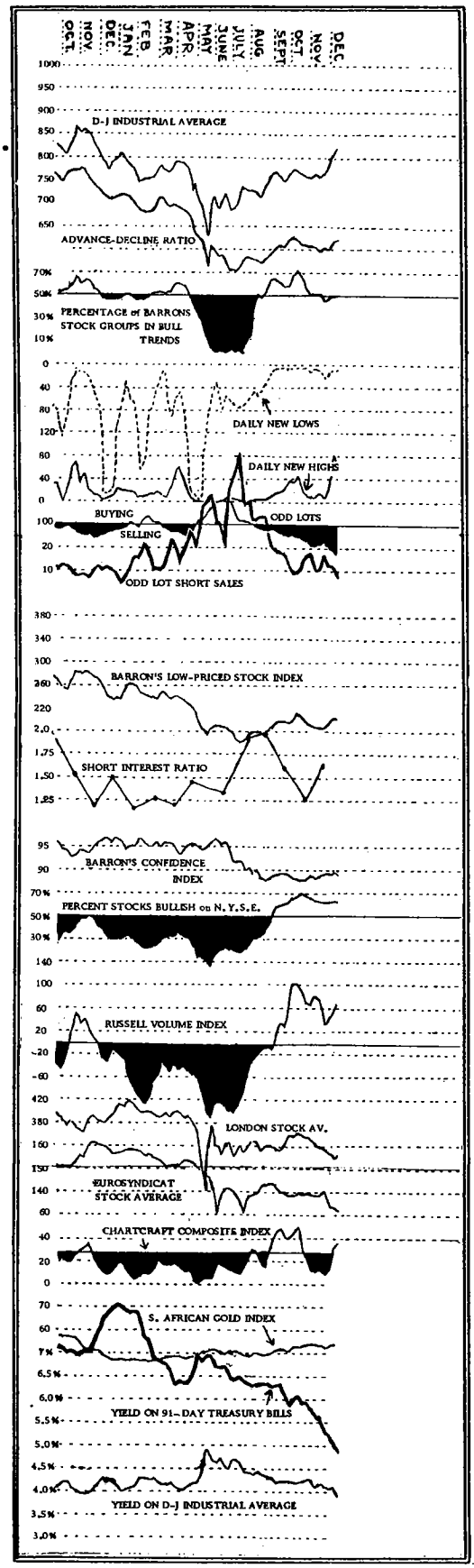
THE PICTURE: In the quarter century since World War II, no U.S. Administration has really taken responsibility for a sane, reasonable economic policy. Expediency, political desires, and "passing the buck" have been the motives behind U.S. monetary and fiscal moves. What might have been a marvelous, steady economic miracle has turned into a mindless economic machine. And, to put it bluntly, the machine has now gone wild!

Within the space of a few years we have seen our economic "planners" move out of a period of wild monetary inflation into one of stiff monetary restraint, and as 1970 ends we see the engines of inflation open wide again. In the face of sliding business and mounting unemployment, our leaders have again unhinged the floodgates, and the result is something akin to economic insanity.

It is an understatement to say that the current period represents the most confusing economic period within the memory of today's sages and soothsayers. Bulls are buying "to beat inflation," knowing full well that the current upthrust in the market is temporary—based on monetary inflation which cannot be allowed to last. Bears are throwing up their hands as they see a greater monster being created than they ever before thought possible. The market itself is split as the stocks of high-grade companies (which can get financing) push upward while the stocks of medium and lesser-grade companies languish, and while still other corporations flounder on the edge of illiquidity, insolvency and even bankruptcy.

The consumer, who is expected to be the bastion of spending and "revival" in the face of monetary expansion, is not acting "according to the books". Confused, angry, questioning, frightened by inflation and overloaded with debt, the consumer has so far refused to rush in and spend his recently accumulated savings.



Meanwhile, Europe (see later section) is anguished and angry over the plight of the dollar, billions of which are held in European central banks as reserves which are supposedly "as good as gold". But far from being as good as gold, these dollar reserves are more and more becoming simply the greatest ocean of fiat currency in world history. The nagging, frightening question here is, how long will Europe stand for U.S. policies which are eroding the value of reserves throughout the Free World?

It all adds up to one of the most frantic economic situations in world history. As things stand, no trend can be trusted, no political statement can be trusted, no analysis can be trusted, no asset can be trusted, no currency can be trusted, no investment position can be trusted. The political and social implications are looming ever larger. Along with the increase in inflation goes an increase in crime, an increase in moral decay, an increase in national restlessness and finally an outpouring in publications across the land of such words as "anarchy", "bombings", "radicalism", and "revolution".

What do I see ahead for 1971? More of the same! For if people can't trust their currency, then they can't trust their Government, and they can't trust their own wisdom or safety. In the face of such insecurity, the nation tends to split into two groups, those who engage in a sort of "dog eat dog" battle to save themselves, and those who turn to thoughts of massive change, a new social and economic order, and a new and more satisfying way of life (even at the cost of anarchy and revolution). So much for the big picture as I see it.

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If you forget "contrary opinion", and you elect to trust the investment bankers' crystal balls, all should be well on Wall Street during 1971. In a poll of bankers at the December 1-4 Boca Raton annual Investment Bankers Association, U.S. News & World Report received about 600 responses. To a question, where are stock prices headed in 1971, 432 bankers said that they were headed moderately or sharply higher, 43 said they were headed moderately or sharply lower (the rest said unchanged). Thus 72% said "up", 7.7% said "down". As to where the Dow will be in mid-1971, 570 bankers said the Dow would be 700 or higher. in mid-1971, 20 said it would be below 700. Thus 96% stated that it would be above 700, and about 4% said it would be below 700. In other words it was almost unanimous that the Dow would be above 700 by mid-1971.

This is a very high degree of bullishness to develop within a corrective rally in a primary bear market. And frankly, I believe that there is an excellent chance that the majority of investment bankers are going to be dead wrong. Bankers are no different than anyone else. They have little or no concept of what a primary trend means, and during a bear market rally they are guided as much by their wishes and emotions as by their brains. Of course, behind all the bullishness I feel that the average banker believes (as does the public) that the power of the Government is the factor which determines the direction of the primary trend.

I want to state again that no government, no treasury or Congress or President, can turn the tide of finance and industry. Governments can pass laws and pump up the money supply and run huge deficits, and in so doing they can hold back the forces of a bear market. But all the Treasuries of the Free World can not turn a bear market into a bull market, and all the legislatures of the Free World cannot turn a bull market into a bear market.

The primary trend will run its course, and the manipulations of governments can only extend (i.e., interrupt) that course temporarily. In the end, the more manipulations and road-blocks in the way of the primary trend, usually the more violent and forceful the ultimate expression of a primary trend.

Look at it this way. The Bull market touched its peak for the Dow in February, 1966, at 995.15. Since then, huge infusions of money have been pumped into the economy, inflations have run rampant, stock market volume has been of record-breaking proportions, all the gold has been removed from U.S. domestic currency and most of the silver has been removed from U.S. coinage, wages have rocketed and production records have been broken, Presidents have attempted to cajole the market up, and leading citizens have proclaimed "a new bull market" on countless occasions, yet none of this has succeeded in taking the Averages to new highs.

In the final analysis, when a market won't go to new highs it is headed for new lows. Over any considerable length of time, the Averages tend to establish successive higher peaks or successive lower lows. When the time is stretched out (as now) this fact can easily be obscured. I am saying that this is still a primary bear market and in time we will smash to new lows, below the 1970 lows. In the mean time, all the huffing and puffing on the upside is simply burning up the bulls' ammunition. When the eventual primary downward slide gets underway, it will be more crushing and more persistent than ever.

Our policy ever since this bear market began has been to avoid the bear. This has meant keeping about 80% of our assets in cash and equivalent with the remaining 20% in assorted gold shares. I have recommended that the "cash" portion of the

portfolio be in 91-day U.S. Treasury bills, and although the yield on these bills has now slipped below 5% I continue to recommend the safety of Treasury bills. Around April of this year (Letter 458) I wrote: "I believe that subscribers may now purchase a limited quantity of AAA-rated bonds. I also believe that a limited quantity of U.S. Treasury bonds may be purchased. If I had to come up with a total current-position formula, I would say that the following seems correct to me: 55% of your assets in Treasury bills, 20% of your assets in assorted gold shares, 25% in top-rated bonds."

Now I want to revise the April recommendation. I would suggest that the bond portion of portfolios be scaled out over the next few months, and that subscribers again assume a position of 80% Treasury bills and 20% gold shares. I would imagine that all top-rated bonds purchased on the Letter 458 recommendation are on the profit side of the ledger. Take the profits, pay the taxes, and call it a year. I don't think bonds are going to be as happy an experience during 1971 as they were during the last half of 1970.

As to the near-term market, little has changed since the last Letter except that the Dow Industrials have pushed up to further new highs— still unconfirmed by Transports. The last confirmed highs of this rally occurred on October 5 and 7, on which days Industrials closed at 783.68 and Transports at 161.15. According to classic Dow Theory, movement terminates at the level at which the two Averages established their last confirmed highs.

Since the October 5-7 period (see chart on page 1) the Industrials have rallied to a high closing of 825.92 (December 11). Transports closed at 158.04 on the same day. The Transport level was three points below the October Transport peak. Since December 11, the Averages have backed off cautiously, and it remains to be seen whether the Transportation Average can better its 161.15 peak, thereby clearing the technical air.

In the absence of a Transport confirmation, the picture will remain suspect with danger increasing the longer the Transports refuse to confirm. I would guess that the Averages are now weighing the prospects for the New Year, and I would further guess that the market is rather edgy about the prospects. The rail and airline industries are now facing a barrage of troubles, and as I read it (and evidently as the Transport Average reads it up to now) there is still no parting of the clouds. Furthermore, the Transport Average is obviously sensitive to prospective shipping prospects over the period ahead, and any decline in shipping and passenger volume during 1971 could easily push the weaker carriers into the Penn Central predicament.

FADS: I have written many times about fads in market analysis. The rationale behind the market fad is obvious enough. Everybody wants to make money (or at least be "right" on the market), and the tool that worked best over the last cycle or two is the one that gets the publicity. I have always warned against jumping on the fad bandwagon, since history has demonstrated that just about the time a particular tool gains wide acceptance, it "mysteriously" seems to lose its predictive value. I have noticed this about technical tools, fundamental tools and even in regard to a particular stock service or "name economist". Beware the man who has a great record over the past few years; chances are he is going to be dead wrong for a while.

One indicator which I will warn against now is the money supply. The money supply is figured in a number of different ways, but the one which I personally follow is the chart put out by the St. Louis Federal Reserve Bank. The money supply figures may be computed differently, but the general direction of most of the figures are the same. At any rate, the whole country is now going crazy over the money supply, although this indicator was hardly mentioned five years ago. As far as I am concerned, I feel that the money supply is an indicator which I am going to be very careful of during coming months. The money supply-stock relationship is now being bandied around in every brokerage office, and as such I would be careful of the usual simplistic conclusions.

I might add that the cause-effect sequence in the money supply could be particularly tricky at this time. Most of the money supply-stock trend studies have been followed during primary bull markets. During a bull market there is a steady, underlying well of confidence, and as the money supply increases this confidence tends to be translated directly into economic expansion and higher stock prices. During a primary bear market, where the underlying confidence is deteriorating (finally giving way to underlying pessimism), the story could well be different. As the old adage goes, "You can lead a horse to water, but you can't make him drink".

As things stand now, with inflation rampant, with consumers loaded up with luxuries, with debt at massive levels, with liquidity low, with unemployment creeping up, with factories facing surplus capacity, there is no guarantee that an increase in the money supply will do anything more than feed the inflationary fires.

Next I come to a technical device which I have written about for a dozen years, the 50% Principle. Suddenly, here in 1970, everybody is talking about the 50% Principle. This is the theory that when a stock recovers more than half of its previous major decline, it is on its way to testing the highs. Or that a stock which fails to recover half of its previous major decline will turn down and test the lows again. This same theorum can be applied to the Averages.

Taking the 1968 peak of 985.21 on the Dow Industrials, we can see that the Dow dropped in a major sweep to the 1970 low of 631.16. This was a drop of 354.05 points. The halfway or 50% retracement level of the 1968-70 decline is 808.18. Under the 50% Principle, any significant close above 808.18 would suggest a continuation of the recovery and an ultimate testing of the old highs.

On December 11, the Dow closed at 825.92, 17 points above the halfway level. Many investment services jumped on this as proof that the bear market was over and that the Dow was on its way to testing the 1968 highs. I warn readers not to jump on the bandwagon. There have been a few notable exceptions to the 50% rule, as Mr. C. Coleman Petty mentioned in a letter to me this week.

For instance, 1929 to 1930 provided an outstanding exception to a mechanical reading of the 50% Principle. From the historic 1929 peak of 381.17 to the November 1929, crash low of 198.69 represented a drop in the Dow of 182.48 points. The halfway recovery level was 289.93. The market turned up in November, and mounted a major recovery into 1930. On April 17, 1930, the Dow closed at a peak of 294.07, less than 2% above the halfway level. From the April peak the Dow turned down again, and by year's end it had lost almost half its value.

The 818.66 closing of December 7, surpassed the halfway level of the 1969-70 decline by about 1.25%, but that penetration served to turn many investment services and individuals bullish on the primary trend. My advice is to lay the 50% Principle aside for a while. I was writing about it when few people had ever heard of it. Now that every Wall Street technician is following it, I would rather not draw conclusions from it.

CHARTS: I have been questioned many times regarding the relative advantages of arithmetic and semi-logarithmic chart paper. It seems to me that the best way to illustrate the advantages and differences is to draw two tracings of the Dow Industrials, one on arithmetic scale and one on semi-log (ratio) scale. That chart is shown on page 5.

First, note on the arithmetic chart that the 1962 to 1966 swing appears as the greatest rise on either chart. And in terms of points gained, it was. But in terms of percentages, the rise from 1949 to 1953 and the rise from 1953 to 1956 were both greater. Therefore, in terms of profitability for those who held high-grade "Dow type" stocks, the earlier rises were more important than the 1962 to '66 affair. Since ratio charting deals in percentages, this phenomenon is shown clearly on the lower chart.

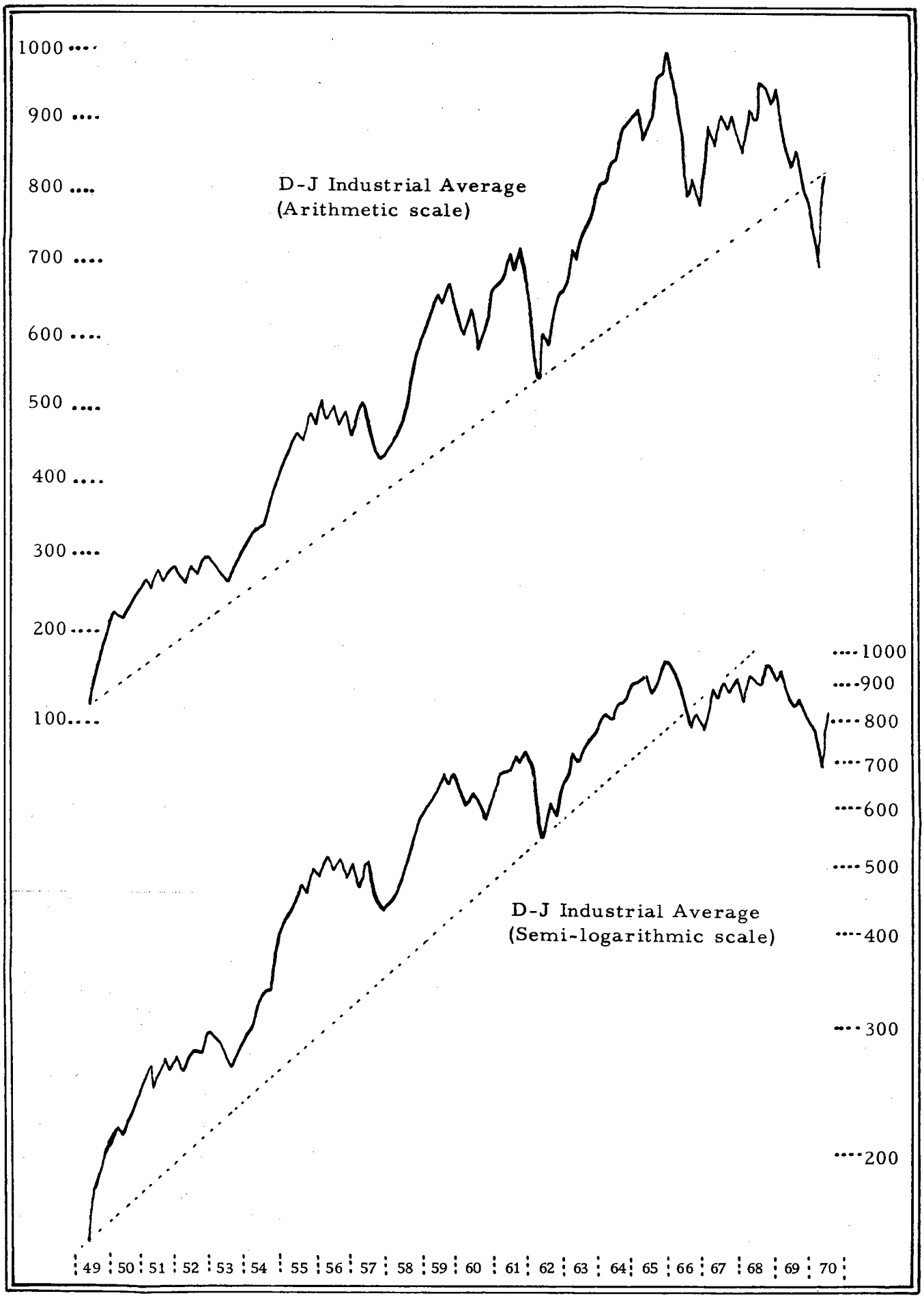
The rationale is simple enough. An advance from 160 to 320 on the Dow represents a doubling of the Average on a rally of 160 points. But a rise from 800 to 960 also represents a move of 160 points. Nevertheless, the advance from 800 to 960 represents an increase of only 20%. On an arithmetic chart, both advances, the rise from 160 to 320 and the rise from 800 to 960 will show as exactly the same distance. On a ratio chart, the rise from 800 to 960 will show as one-fifth the rise from 160 to 320, since the former is only a 20% rise while the latter (i.e., 160 to 320) represents a 100% rise.

When dealing with the 50% Principle, for instance when checking to determine what the Average does at the halfway point of a previous advance or decline, the arithmetic chart is more useful. The halfway point of a preceding advance or decline will appear on an arithmetic chart as exactly on the halfway mark (as measured on a pair of dividers). For instance, it is obvious on the top tracing that the 1969-70 plunge broke well below the halfway point of the entire 1962-66 rise. On the lower ratio scale chart, this is not obvious at all.

Finally, the ratio (lower) chart is superior in showing trendlines. On a ratio chart, a steady rate of advance will appear as a straight line or a steadily rising percentage. Note that the two trendlines on the two charts both connect the 1949 and 1962 bottoms. But the lower ratio chart shows that the rate of rise which held from 1949 through 1962 was reversed during the 1966 decline. This was an important warning signal indicating that a 17-year growth rate had been ruptured. I wrote at the time that this reversal of a 17-year trendline had very bearish connotations.

Those who followed arithmetic charts did not receive this information. The trendline connecting the 1949 and 1962 bottoms was not broken on the arithmetic chart until early 1970, at which times those who were holding stocks were already showing huge losses.

In the final analysis, I would suggest that all serious market students keep charts of the Averages on both arithmetic and ratio scale. For long-term investors, I find a weekly high-low and closing chart is perfectly adequate. A constant study of the two types of charts will afford the student a "feel" for the market which will prove indispensible over the years.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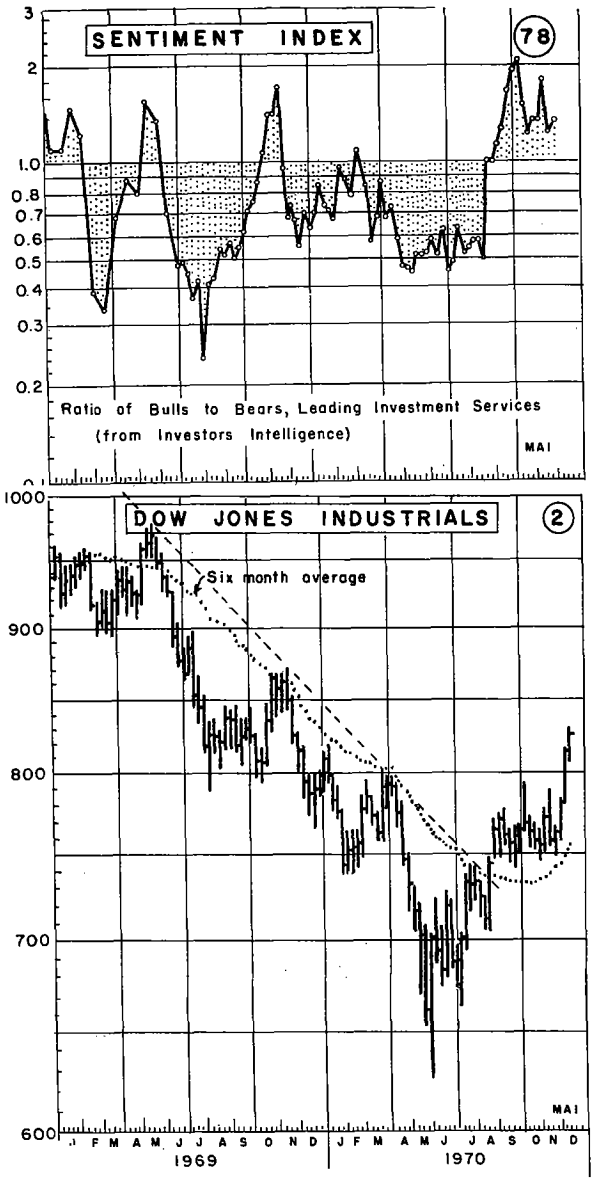


PROFESSIONAL SENTIMENT: William P. Hamilton, famous Editor of the Wall Street Journal during the 1920's, stated that he had "never known the majority of professionals on Wall Street to be right". There is no way of actually polling the majority of professionals with complete accuracy, but Investors Intelligence keeps a tabulation on about 60 of the leading investment advisory services (bullish or bearish), and Merrill Analysis (Box 228, Chappaqua, N.Y. 10514) works these tabulations into a ratio and occasionally publishes their ratio chart.

I have taken Merrill's recent Sentiment Index chart and superimposed it on the weekly chart of the Dow Industrials. The picture is rather interesting. Note that the ratio rose above 1.0 on four occasions during the 1969-70 period. The first, in February, 1969, was followed by a drop from the 950 to the 900 area on the Dow. The second bullish area on the part of the services occurred in May, 1969. This was followed by a massive decline from the 975 area down to below 800 for the Dow. The third bullish area for the services came in November, 1969, with the Dow at around 875. This was followed by the final smash to the 631.16 low of May, 1970.

The big retracement in the Dow started turning the services bullish around August-September, 1970. By October, the ratio made its first move above 2.0 for the first time, and since then it has stayed in the area between 1 and 2, showing that the services retain a high degree of bullishness. In the face of this persistent bullishness on the part of the investment services, it will be interesting to see whether this contrary-opinion index retains its accuracy.

The National Observer (Dec. 14) published a story regarding financial problems of the various states. I include a bit of that pathetic, absurd article on this page. Many years ago a wealthy Swiss subscriber visited me in New York and told me this story. "You know," he said, "One day I was looking out of my hotel room overlooking the Hudson, and I observed two large ships heading towards each other. I said to myself casually, if those two ships continue on their current paths they will collide, but that is ridiculous, because large ships almost never collide, and they will surely see what is going on and change courses. Three minutes later, with a sickening roar and tearing of metal, the two ships collided."

The old Swissman has since died, but I have never forgotten his story. Perhaps the Governors of some of our states should hear my friend's tale of two ships in the Hudson River.

Speaking of collisions, I wrote up TWA in Letter 467 as a potential disaster. Today it was announced that TWA's November loss was $16 million. Words fail me.

***Politics by Perry***

# It's Twilight in Pennsylvania And the Bills Are Coming Due

By James M. Perry
FROM HARRISBURG, PA.

If Pennsylvania fired its governor and lieutenant governor, fired the entire state legislature, fired all of its employes—it still could not save the $450,000,000 in fresh revenue it needs to stagger through the final four months of this fiscal year.

Pennsylvania, the nation's third-largest state, has a fiscal problem.

It needs that additional $450,000,000 to operate state services at current levels in March, April, May, and June. Then, for the new fiscal year that will begin July 1, it needs at least $1.2 billion in additional fresh revenue. It needs all this money just to meet obligations it already has incurred.

Pennsylvania's fiscal problem is not unusual; it is just dramatic. New York State, according to Nelson Rockefeller, needs an additional $2.5 billion to stay in business. California is facing an illegal deficit of $500,000,000. A new governor in Ohio will be forced to impose new taxes.

Says Governor Rockefeller:

"We are witnessing a situation where state and local governments cannot deliver essential services people need and rightfully expect. Consequently, we've got to face the fact that public confidence in government is beginning to break down."